No. 15,532

In the United States Court of Appeals for the Ninth Circuit

ARTHUR L. LAWRENCE AND ALMA P. LAWRENCE,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

On Petition for Review of the Decision of the Tax Court of the United States

BRIEF FOR THE RESPONDENT

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CITATIONS

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BRIEF FOR THE RESPONDENT

OPINION BELOW

The opinion of the Tax Court (R. 35-50 is reported at 27 T. C. 713.

JURISDICTION

This petition for review (R. 52-53 involves income tax for the year 1948 in the amount of $2,931.14. On May 10, 1954, the Commissioner of Internal Revenue mailed to taxpayers a notice of deficiency in the amount of $2,931.14. (R. 9-12.) On July 22, 1954 (R. 12), taxpayers filed a petition (R. 3-12)

with the Tax Court for a redetermination of that deficiency under the provisions of Section 272 of the Internal Revenue Code of 1939. The decision of the Tax Court was entered on January 31, 1957. (R. 51.) The case is brought to this Court by petition for review filed March 20, 1957. (R. 52-53.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

QUESTIONS PRESENTED

1. Whether taxpayers omitted from gross income an amount properly includible therein in excess of 25 per centum of the amount of gross income stated in the return, so as to bring into play the five-year statute of limitations of Section 275(c) of the Internal Revenue Code of 1939.

2. Whether the Tax Court erred in holding that even if a prior decision of this Court is indistinguishable, it is not controlling upon the Tax Court.

STATUTE INVOLVED

Internal Revenue Code of 1939:

Sec. 275. Period of Limitation Upon Assessment and Collection.

Except as provided in section 276—

(a) *General Rule.*—The amount of income taxes imposed by this chapter shall be assessed within three years after the return was filed, and no proceeding in court without assessment for the collection of such taxes shall be begun after the expiration of such period.

* * * *

(c) *Omission from Gross Income.*—If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 per centum of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 5 years after the return was filed.

* * * *

(26 U.S.C. 1952 ed., Sec. 275.)

STATEMENT

The facts, as stipulated (R. 16-34) and adopted as the findings of fact of the Tax Court (R. 36), may be summarized as follows:

Taxpayers filed a joint income tax return for the calendar year 1948 on May 31, 1949. (R. 16.) On May 10, 1954, more than three but less than five years thereafter, the Commissioner mailed a notice of deficiency in income tax in the amount of $2,-931.14. The only question presented to the Tax Court was of the applicability of the statute of limitations. (R. 17.)

Taxpayer Athur L. Lawrence was a stockholder of the Midway Peerless Oil Company. This company was dissolved and its assets distributed to its stockholders in complete liquidation in 1948. (R. 17.) Among the assets distributed were a lease, leasehold equipment, buildings, inventories, and cash and other assets. (R. 29.)

Schedule D of taxpayers' return for 1948 showed a gross sales price for assets received from Midway Peerless Oil Company of $10,539.71, and a basis for

the stock of $1,899.90, the gain being treated as long-term capital gain. (R. 27.) The gross price reflected the value of the items received other than the lease and inventory. The value of the lease and inventory were not included in Schedule D because taxpayers claimed that they had no ascertainable market value. (R. 30.) The Commissioner determined that the lease had a fair market value of $20,-104.18 and the inventories a fair market value totalling $89.18. (R. 33.) The deficiency of $2,931.14 arose from a recomputation of taxpayers' income for 1948, including those items.

There is no dispute as to the amount of the deficiency, as to the value of the lease, or as to the fact that the amount of $20,104.18 plus $89.18, or even the taxable one-half of that amount, meets the 25 per cent requirement of Section 275(c) of the Internal Revenue Code of 1939. (R. 17, 36-37.)

Taxpayers' return appears in the record. It is on Form 1040 (R. 18-19) which contains a "Schedule D—Gains and Losses from Sales or Exchanges of Capital Assets, etc." showing the amount of $4,-491.78 (R. 19). A seperately itemized Schedule D (R. 27) includes among other long-term gains and losses an item for Midway-Peerless Oil Company, showing a gross sales price of $10,539.71 and a cost or other basis of "(A) $1,899.90." A separate typed sheet, headed "Schedule D—Note A" (R. 29-30) and also headed "Computation of Gain on Liquidation of Midway Peerless Oil Company" contains a schedule of the value of assets distributed, an explanation that the lease had no ascertainable market value and

that the inventories were part of the lease, and a "Computation of Value Received During 1948 by Arthur L. Lawrence." This latter listed the value of the cash received, leasehold equipment, and buildings, set out the total value received as $10,539.71, the basis of the stock as $1,899.90, and the realized long-term gain as $8,639.81.

The Tax Court held that "It is obvious from the entire return that the taxpayers made a computation of their income and omitted 'from gross income an amount properly includible therein which is in excess of 25 per centum of the amount of gross income stated in the return' " (R. 40) and accordingly that the notice of deficiency was timely.

SUMMARY OF ARGUMENT

I

The income derived by taxpayers from the distribution to them of an interest in the lease was omitted from their gross income under the clear language of the statute. Although receipt of a lease interest was set out in a schedule attached to the return, it was nowhere reported *as income* nor does it appear in any of the computations of income.

Unless it is to be held that disclosure somewhere in the return of the receipt of property later determined to be income is sufficient, then Section 275(c) is clearly applicable. None of the decisions of this or other Courts of Appeals goes so far. On the contrary under the decisions of this Court the amount was omitted from gross income. The Tax Court's decision is in accord with those of the Second and

Sixth Circuits and not in conflict with those of the other circuits. It is also supported by the legislative history of Section 275(c) and by congressional statements of its intention to change the law by Section 6501(e) of the Internal Revenue Code of 1954.

II

In reaching its decision the Tax Court did not disregard a controlling decision of this Court. On the contrary, it decided an issue at the very least left open by earlier decisions of this Court. Even if there were a decision of this Court squarely in point, however, the Tax Court, for the reasons set out in its opinion, did not err in deciding this case on the basis of its view of the correct application of the statute.

ARGUMENT

I

The Tax Court Correctly Held That Taxpayers Had Omitted 25 Per Cent of Their Gross Income Within the Meaning of Section 275(c) of the Internal Revenue Code of 1939

As the Tax Court points out, it is obvious that taxpayers did not include in their taxable income as shown on the return the item of income here in question. It is not reflected in Item 6 on page 1 of the return (R. 18); it is not reflected in the summary Schedule D on page 2 (R. 19); it is not included in the itemized Schedule D (R. 27); it is left out of the "Computation of Value Received During 1948" on the sheet attached to Schedule D (R. 30).

That sheet did show that Lawrence received some property, an interest in a lease, not included in his statement of income, but that item was deliberately excluded and omitted by him in each of the computations of his reportable income. He clearly "omits from gross income an amount properly includible therein," and this amount is in excess of 25 per cent of "the amount of gross income stated in the return." Section 275(c), Internal Revenue Code of 1939, *supra*. He did report that he received the lease interest, but not that he received it as income. Taxpayers' argument is in substance that an amount which they deliberately, though mistakenly and in good faith, omitted from their statements of income, was nevertheless not omitted from income because the receipt of the amount was disclosed.

In all of the computations purporting to show taxpayers' *income* this amount is omitted. In this respect this case is clearly distinguishable from *Slaff* v. *Commissioner*, 220 F. 2d 65 (C. A. 9th). There the taxpayer stated on the first page of his return, under the heading "Income" the following (p. 66):

> American Red Cross—Overseas Sept. 1942 to Dec. 1944. Income received $3,300; exempt under Section 116 I.R.C.; therefore no taxable income.

This Court held that there was in those circumstances no omission because there had been "full disclosure on the face of the return." There, however, the taxpayer did report the $3,300 *as income*, and made full disclosure that it was income. Here the taxpayers did not.

Taxpayer here did not even go as far as the taxpayer did in *O'Bryan* v. *Commissioner*, 148 F. 2d 456 (C. A. 9th), in reporting gross income on the face of the return. There the taxpayer, because of the terms of a separation agreement with his wife, was taxable on his entire income. He paid taxes on only one-half on a return filed in his own name, and taxes on the other half on a return filed by him in his wife's name. On his return for 1936 was reported under the general heading of "Income," Item 1, salaries, wages, commissions, fees, etc. as follows:

		Amount Received	Expenses Paid
	(		
O'Bryan Bros., Inc.	(	$10,250	$1,029.50
	(	20,500	2,059.00

In the column opposite Item 1 the difference between the amount received and the expenses paid, or $9,-220.50, is shown. The "Total Income in Items 1 to 11" is shown as $9,591.50.[1] This Court rejected taxpayer's argument that there was no omission because the full amount of his income appeared on the face of the return, saying (pp. 459-460):

> The mere appearance of the total amount of gross income somewhere on the face of an income tax return is not sufficient to prevent an omission within the terms of §275(c). The government is not required to search carefully throughout a tax return to ascertain some fact which will put it on notice of error. It is apparent

[1] See page 28 of the record in that case for a photograph of the return.

> from the pertinent legislative history that care and good faith will not prevent the applicability of subsection (c).

In the present case, the taxpayers nowhere stated the full amount of their income as an item of income. In this respect, at least, they did not even do as much as was done by O'Bryan. Nevertheless that was held insufficient.

Taxpayers in their brief (pp. 20-25) do not refer to the *O'Bryan* case, but rely primarily on this Court's decision in the *Slaff* case and on two Third Circuit cases, *Uptegrove Lumber Co.* v. *Commissioner*, 204 F. 2d 570, and *Deakman-Wells Co.* v. *Commissioner*, 213 F. 2d 894, which this Court referred to with approval in *Slaff*, p. 68. This Court, in the *Slaff* case, referred to and distinguished, but did not indicate any disapproval of its earlier decision in the *O'Bryan* case, which we take to remain in force as a precedent for similar cases. We submit that the present case presents an omission from gross income much closer to the *O'Bryan* situation than to the *Slaff* situation.

Similarly, the Tax Court cited this Court's approval of *Uptegrove* and *Deakman-Wells* as evidence that in *Slaff* this Court was approving the views of the Third Circuit in a case like the present one. (R. 43.) As the Tax Court points out, the opinions in those cases indicate that the Third Circuit would hold in a case like the present one that there was an omission from gross income. In *Uptegrove* v. *Commissioner*, 204 F. 2d 570, 573, the court referred to three earlier

cases,[2] and said—

> These cases all involved failures to enter certain items of gain in the gross income sections of returns. Each taxpayer relied upon the fact that somewhere else in his return, or in some statement attached to it, he had revealed the existence of the item in question though he did not report it as gain taxable to himself.

The court went on to say that even if there was disclosure and the intent of the statute was to offset the mischief of concealment—

> the courts could not reach these policy considerations because the applicability of the language of the statute, "omits from gross income," to the given facts was so clear.

There the court held that there is an omission "only when he leaves some item of gain out of his computation of gross income," emphasizing "the character of gross income as a computation" (204 F. 2d 570, 571), and emphasized there and in *Deakman-Wells Co.* v. *Commissioner*, 213 F. 2d 894, 897, that there is no omission if the questioned item appears in the computation even if "eliminated in the computation of the final figure." The rule of those cases, then, appears to be that a disclosure of an item somewhere in the return is not enough, but that the disclosure must be at some point in the computation itself. To the same effect are *Davis* v. *Hightower*, 230 F. 2d 549,

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[2] *Ewald* v. *Commissioner*, 141 F. 2d 750 (C. A. 6th); *Ketcham* v. *Commissioner* 142 F. 2d 996 (C. A. 2d); and *O'Bryan* v. *Commissioner*, 148 F. 2d 456 (C. A. 9th).

553 (C. A. 5th), and *Goodenow* v. *Commissioner*, 238 F. 2d 20 (C. A. 8th). Though we submit that even in the situations involved in those cases the different result reached by the Sixth Circuit is preferable (*Colony, Inc.* v. *Commissioner*, 244 F. 2d 75, petition for certiorari filed, July 22, 1957; *Reis* v. *Commissioner*, 142 F. 2d 900), in any event the decision of the Tax Court in the present case is consistent with the rule announced by the Third Circuit and approved by this Court in the *Slaff* case.

Furthermore, although taxpayers cite recent cases in their brief (pp. 20-21), the earlier decisions on this problem remain outstanding. See, for example, *Ewald* v. *Commissioner*, 141 F. 2d 750 (C. A. 6th),[3] where it was held that Section 275(c) was applicable although the omission was not negligent.

In *Carew* v. *Commissioner*, 215 F. 2d 58 (C. A. 6th), taxpayer had included in his statement of "Cost of Goods Sold" such items as "Alimony Settlement," thereby overstating the cost of goods sold and understating his gross profit. It was held that there was an omission even though on the information given the Commissioner could have revised the return.

Ketcham v. *Commissioner*, 142 F. 2d 996, 997 (C. A. 2d), is directly in point on the factual situation in the present case. There the question was whether certain income was taxable to a divorced wife or was alimony. It was held taxable to her and the five-year statute of limitations was applied, because she had

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[3] Cited with approval by this Court in the *O'Bryan* case.

omitted this income from her return. The court stated—

> That she attached schedules to her returns, stating that she had received certain amounts as trust income in lieu of alimony, but that such amount was taxable to her husband, cannot relieve her from the effect of having omitted those amounts from her gross income.

To sum up the decisions, it appears that under those of the Second and Sixth Circuits disclosure of the receipt of income somewhere in the return is not sufficient to render Section 275(c) inapplicable; even under the decisions of the Third, Fifth, and Eighth Circuits a disclosure sufficient to cure the omission must appear in the computations of gross income and it is not enough if the disclosure appears elsewhere. Under the two decisions of this Court, the question appears to be an open one. In the *Slaff* case the disclosure appeared in the computation; in *O'Bryan*, the reference was in the computation, but was inadequate as a disclosure.[4] We submit, however, that in the present case the disclosure did not appear in the computation of gross income, so that even under the rulings of the Third Circuit there was an omission from gross income, so there is "no relevant ambiguity in the statute to warrant the consideration of its purpose in order to discover its meaning." *Uptegrove Lumber Co.* v. *Commissioner*, 204 F. 2d 570, 573.

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[4] In the *O'Bryan* case this Court cited with approval the Second and Sixth Circuit cases, *Ewald* v. *Commissioner, supra, Reis* v. *Commissioner, supra,* and *Ketcham* v. *Commissioner, supra.* In the *Slaff* case it cited with approval the two Third Circuit decisions.

Taxpayers assert that the legislative history shows that "The basic test was negligence of the taxpayer in omitting to report items of income, * * *." (Br. 17-18.) It is clear, however, that the statute was not directed solely to cases of negligence. As this Court said in *O'Bryan* v. *Commissioner*, 148 F. 2d 456, 460:

> It is apparent from the pertinent legislative history that care and good faith on the part of a taxpayer will not prevent the applicability of subsection (c).

The pertinent committee reports make this abundantly clear.

The provisions of subsection (c) of Section 275 first appeared in Section 275(c) of the Revenue Act of 1934, c. 277, 48 Stat. 680. The bill originating in the House changed Section 276 of the Revenue Act of 1932, c. 209, 47 Stat. 169, relating to false or no returns, and carried no period of limitations. The reason for the provisions was stated in a subcommittee report published as part of the House Hearings before the Committee on Ways and Means, 73d Cong., 2d Sess., Revenue Revision of 1934, p. 139, as follows:

> Section 276 provides for the assessment of the tax without regard to the statute of limitations in case of a failure to file a return or in case of a false or fraudulent return with intent to evade tax.
>
> Your subcommittee is of the opinion that the limitation period on assessments should also not apply to certain cases where the taxpayer has understated his gross income on his return by a large amount, even though fraud with intent to

> evade tax cannot be established. It is, therefore, recommended that the statue of limitations shall not apply where the taxpayer has failed to disclose in his return an amount of gross income in excess of 25 percent of the amount of the gross income stated in the return. The Government should not be penalized when a taxpayer is so negligent as to leave out items of such magnitude from his return.

The full Committee adopted this reasoning as part of its report, published in H. Rep. No. 704, 73d Cong., 2d Sess., p. 35 (1939-1 Cum. Bull. (Part 2) 554, 580), as follows:

> Section 276(a). No return or false return: The present law permits the Government to assess the tax without regard to the statute of limitations in case of failure to file a return or in case of a fraudulent return. The change in this section continues this policy, but enlarges the scope of this provision to include cases wherein the taxpayer understates gross income on his return by an amount which is in excess of 25 percent of the gross income stated in the return. It is not believed that taxpayers who are so negligent as to leave out of their returns items of such magnitude should be accorded the privilege of pleading the bar of the statute.

The Finance Committee of the Senate incorporated the modification in the same language into Section 275 except that it provided for a five-year period of limitations. It was this provision that was finally enacted into law. In its report (S. Rep. No. 558, 73d Cong., 2d Sess., pp. 43-44 (1939-1 Cum. Bull. (Part 2) 586, 619)) the Committee said:

> The present law permits the Government to assess the tax without regard to the statute of limitations in case of failure to file a return or in case of a fraudulent return. The House bill continues this policy, but enlarges the scope of this provision to include cases wherein the taxpayer understates gross income on his return by an amount which is in excess of 25 percent of the gross income stated in the return. Your committee is in general accord with the policy expressed in this section of the House bill. However, it believed that in the case of a taxpayer who makes an *honest mistake,* it would be unfair to keep the statute open indefinitely. *For instance, a case might arise where a taxpayer failed to report a dividend because he was erroneously advised by the officers of the corporation that it was paid out of capital* or he might report as income for one year an item of income which properly belonged in another year. Accordingly, your committee has provided for a 5-year statute in such cases. (Italics supplied.)

From the foregoing it appears that in the preliminary stages the discussion was directed primarily to negligent omissions and *no statute of limitations* at all. As modified by the Senate and finally enacted the section was intended to cover non-negligent omissions but instead of no limitation period to provide the five-year period.

It is clear that the intent was to fix a period of limitations longer than the three-year one where there was a 25 per cent omission regardless of the case and good faith of the taxpayer and no matter how honest his mistake. In fact, the illustration

given in the Senate Committee report, italicized above, of the sort of omission covered by the statute, the honest but mistaken belief that an amount received was not income, is strikingly similar to what occurred in the present case.

As this Court pointed out in *Slaff* v. *Commissioner*, 220 F. 2d 65, 67, Congress in the Internal Revenue Code of 1954 has solved this problem for the future in Section 6501(e), reading in part as follows:

> SEC. 6501. LIMITATIONS ON ASSESSMENT AND COLLECTION.
>
> * * * *
>
> (e) *Omission From Gross Income.*—Except as otherwise provided in subsection (c)—
>
> (1) *Income taxes.*—In the case of any tax imposed by subtitle A—
>
> (A) *General rule.*—If the taxpayer omits from gross income an amount properly includible therein which is in excess of 25 percent of the amount of gross income stated in the return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within 6 years after the return was filed. For purposes of this subparagraph—
>
> (i) In the case of a trade or business, the term "gross income" means the total of the amounts received or accrued from the sale of goods or services (if such amounts are required to be shown

> on the return) prior to diminution by the cost of such sales or services; and
>
> (ii) In determining the amount omitted from gross income, there shall not be taken into account any amount which is omitted from gross income stated in the return if such amount is disclosed in the return, or in a statement attached to the return, in a manner adequate to apprise the Secretary or his delegate of the nature and amount of such item.
>
> *   *   *   *

(26 U.S.C. 1952 ed., Supp. II, Sec. 6501.)

The Tax Court pointed out that the legislative history states that this was a change from existing law. (R. 41.) Taxpayers disagree. (Br. 18-20.)

The Committee Reports, however, are explicit, stating in identical language (H. Rep. No. 1337, 83d Cong., 2d Sess., p. A 414 (3 U.S.C. Cong. & Adm. News (1954) 4017); S. Rep. No. 1622, 83d Cong., 2d Sess., p. 584 (3 U.S.C. Cong. & Adm. News (1954) 4621)) that—

> Several changes from existing law have been made in subsection (e) of this section. In paragraph (1), which relates to income tax, the existing 5-year rule in the case of an omission of 25 percent of gross income has been extended to 6 years. The term gross income as used in this paragraph has been redefined to mean the total receipts from the sale of goods or services prior to diminution by the cost of such sales or

> services. A *further change from existing law* is the provision which states that any amount as to which adequate information is given on the return will not be taken into account in determining whether there has been an omission of 25 percent. (Italics supplied.)

Furthermore, the rule set out in the 1954 Code goes beyond the decisions discussed above in accepting a disclosure "in the return, or in a statement attached to the return." [5] The Tax Court recognizes that under the 1954 Code taxpayers' position would be correct. (R. 41.) That Code, however, did not re-enact existing law; it changed the law.

II

The Prior Decision of This Court Is Distinguishable, But If It Is Not the Tax Court Was Not Bound To Follow It

Taxpayers argue that *Slaff* v. *Commissioner, supra,* is a clear holding of this Court in support of its position (Br. 25) and that it was error for the Tax Court to refuse to follow it. The Tax Court, however, believed that the *Slaff* case was distinguishable. (R. 42-43.) In Point I, above, we have set out our reasons for urging that the *Slaff* case is not controlling here. In any event, we submit that its applicability is not clear, both for the reasons given by the Tax Court (R. 42-43), and also because of the *O'Bryan* decision.

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[5] Of course there remains the problem in each case of determining whether the disclosure is "adequate."

If, however, this Court should conclude that the position of this Circuit was clearly set out in the *Slaff* opinion and is in favor of the taxpayers, and should find it necessary to consider the second issue, we submit that the Tax Court was correct for the reasons as set out in its opinion (R. 43-49), as written by Chief Judge Murdock and reviewed by the entire court.

CONCLUSION

The decision of the Tax Court is correct and should be affirmed.

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